

COMMENTARY

SHELDON H. ELSEN*

As a trial lawyer with practical experience in the area of corporate misconduct, I have had the opportunity to deal firsthand with the rules governing conduct in various corporations. Based upon my experience representing corporations and corporate executives, I agree with Professors Deborah A. DeMott¹ and James D. Cox² that the rules actually governing conduct are often different from those written in compliance programs and codes of conduct. However, while Professor DeMott refers to these unwritten rules as incentives to break the law, my experience leads me instead to characterize them as pressures to break the law. I believe this difference in language carries with it a different appraisal of the resulting misconduct, and a somewhat different sense of what to do about it. Specifically, I can think of two situations I have experienced that lead me to this characterization.

The first situation involved foreign bribery investigations. In response to the SEC's campaign to require public companies to disclose foreign bribery, I was retained by a Fortune 100 company that had food operations all over the world. I still vividly remember arriving in a third world country and meeting with the company's middle management. They were in despair because the company was now looking critically at activities they believed senior management knew about and condoned. For example, in an effort to get a license from the local authorities for a three-inch water pipe into the plant, a plant manager with the company let a local on his staff bribe the authorities, because the authorities were insisting they would permit only a one-inch pipe. The plant manager and everyone at the plant knew bribery had to be used. Thus, when the plant manager learned that the head of the company's international division and senior management had denied any knowledge of these activities, he scoffed and rather bitterly said that he himself had no wish to engage in these types of activities—he taught Sunday school and was trying to bring up his children according to an American middle-class value system. Everyone knew what had to be done to do business in that country, yet he was being saddled with the blame.

No criminal or civil cases grew out of this or most foreign bribery investigations, but the result was that many middle managers, like the plant manager I

Copyright © 1997 by Law and Contemporary Problems

This article is also available at <http://www.law.duke.edu/journals/lcp>.

* Senior Partner in the law firm of Orans, Elsen & Lupert and Adjunct Professor of Law, Columbia University.

1. See Deborah A. DeMott, *Organizational Incentives to Care About the Law*, 60 LAW & CONTEMP. PROBS. 39 (Autumn 1997).

2. See James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, 60 LAW & CONTEMP. PROBS. 1 (Autumn 1997).

had met, lost their jobs, while senior management adopted a holy code of ethics and avoided dismissal. Yet those middle managers were not rogues, and if there was to be responsibility, it should have been assumed by the entity and vicariously by the people at the top.

The second situation I experienced that leads me to characterize unwritten corporate rules as pressures to break the law rather than incentives involved an investigation of a major broker-dealer that had offices throughout the United States. In that case, branch managers and regional administrators with a responsibility to supervise major producers who were stepping over the line found themselves stymied when they tried to bring their concerns up the ladder to senior management. There was an unwritten rule in the company that the big producers were to be looked after. As a result, middle management was left to deal with the consequences of overstepping by big producers. While the resulting case was notorious, senior management essentially escaped unharmed, but the middle managers had to file Wells submissions and may well have become the subject of SEC disciplinary proceedings had not the *Johnson*³ case intervened to bar such cases through the statute of limitations.

Accordingly, based on these experiences, I am inclined to agree with Professors DeMott and Cox that entity liability or vicarious liability is an appropriate response to unacceptable behavior arising from the corporation's business activities. In addition, I think that senior management should have responsibility thrust on it vicariously, and there should be more compassion for the middle managers who are forced either to carry out the company's wishes or risk losing their jobs.

However, I have greater reservations with regard to personal liability for directors. As Chancellor Allen persuasively argues, too tough an enforcement of the duty of care could make it hard for corporations to attract outside directors.⁴ In response to this possible problem, Professor DeMott attempts to find a reasonable halfway point by which directors can be held accountable when senior management itself has become involved in wrongdoing. She suggests drawing on the standards for entity liability as set forth in the Federal Sentencing Guidelines for Organizations,⁵ which decree that a corporation lacks an effective compliance program when senior management or certain supervising employees are complicit in wrongdoing.⁶ However, for the reasons I have given, it is sometimes hard to say when senior management has been complicit. Here, as elsewhere, the Sentencing Guidelines are not always wise or accurate. It does not seem unreasonable to say, as Professor DeMott does, that the directors should have the burden of demonstrating their good faith in a situation

3. See *Johnson v. SEC*, 87 F.3d 484, 492 (D.C. Cir. 1996) (applying the five-year statute of limitations of 28 U.S.C. § 2462 to an SEC proceeding seeking censure and suspension of a securities supervisor under § 15(b) of the Securities Exchange Act of 1934).

4. William T. Allen, Address at the Duke University School of Law/Institute for Law and Economic Policy's Conference on Deterring Corporate Misconduct (Nov. 15, 1997).

5. See DeMott, *supra* note 1, at 63-64.

6. See U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(f) (1997).

where senior management has been complicit in wrongdoing.⁷ But the question of proving such complicity may be a thorny one.

When there has been a criminal investigation, as in the *Caremark*⁸ case as well as actions involving Salomon Brothers⁹ and Prudential Securities,¹⁰ the company comes under pressure from law enforcement to give up its senior officials in order to save the company. In *Caremark*, the company did not take such action, but in the Salomon Brothers proceeding, the top people were surrendered in order to save the company.

Putting the finger on senior management may thus happen fortuitously. If the directors of a corporation that has been the subject of criminal investigation are to be more exposed to personal liability than the directors of a corporation where there has been wrongdoing but no criminal investigation, similar cases may not be treated alike. Plaintiffs would have an easier time pleading and proving the misdeeds of senior management where there has been an investigation, particularly where senior management has admitted complicity as in Salomon Brothers, but plaintiffs might have to put in a substantial case to prove complicity of senior management when there has been no criminal investigation.

The result may be that, if the shift of the presumption were considered important, the parties might have to engage in a sideshow at trial over the complicity of senior management, rather than focus on evidence about the directors. This might not be so if senior management were co-defendants, but that is not always the case.

Perhaps more importantly, I have some question about how much difference shifting the presumption would make in a case where the directors could meet their burden of showing good faith simply through their testimony, thus leaving it for the plaintiff to prove an absence of good faith from the circumstantial evidence, much as the plaintiff has to today.

Thus, the result of Professor DeMott's innovation might be a scattering of results, a possible increase in the cost of litigation, and a sense that similar cases are not being treated alike. While I agree with Professor DeMott that directors should be held accountable if they wink at a situation in which senior management has created a culture that invites wrongdoing, I believe her concept requires refining.

As to Professor Cox's article, I am generally in agreement. However, I do question his conclusion that the class action has fallen out of favor. He bases

7. See DeMott, *supra* note 1, at 63-65.

8. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (holding that a board of directors has an affirmative duty to ensure the appropriate supervision of the corporation's employees and agents).

9. In this action, the Chief Executive and General Counsel of Salomon Brothers were administratively disciplined for failure to supervise misconduct on lower levels within the firm.

10. See generally KURT EICHENWALD, *SERPENT ON THE ROCK* (1995).

this conclusion on the opinions of conservative Justices in *Blue Chip Stamps*¹¹ and *Central Bank*,¹² and the 1995 Private Securities Litigation Reform Act.¹³ However, there are still Supreme Court Justices as well as many lower court judges who view the class action as the Supreme Court did in *Borak*.¹⁴ Furthermore, I can say from my own involvement in the congressional debates surrounding the 1995 Reform Act that despite the changes there remained a consensus among the members of Congress that the class action should be preserved. During the debates, critics of the class action had introduced harsher provisions that would have effectively killed class actions. Specifically, critics introduced provisions to require "loser pays,"¹⁵ the destruction of the fraud on the market theory, and pleading requirements for scienter that would have been impossible for plaintiffs to meet.¹⁶ But these provisions were essentially all removed by what I like to think of as the informed majority of the Senate. While the bill that passed could indeed be characterized as critical of what Congress considered excesses in class action practice, a majority of Congress as well as the President all acted on the basic premise that the class action plays a useful role and should be preserved.¹⁷

I am also in agreement with Professor Cox's criticism of the law and economics analysis of Professor Arlen and others.¹⁸ I add only that I think he has been too kind. Professor Arlen's analysis starts from the premise that corporate conduct is based on a calculus of what will make the most money.¹⁹ But when corporate officers are considering what to do, they normally cannot make those kinds of dollars and cents calculations. Professor Arlen's hypothesis that abandonment of compliance programs will ultimately save the corporation money strikes me as rather naive. Indeed, the consequences of wrongdoing may not only be civil; they may be criminal as well. Wrongdoing may or may not be covered by insurance. In addition, if a scandal erupted in the newspapers, management could be turned out. Thus, a compliance program is gener-

11. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (finding that standing to bring a private damages suit under Rule 10b-5 is limited to actual "purchasers" or "sellers" of securities as defined in the Securities Exchange Act of 1934).

12. See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (holding that a private plaintiff may not bring an aiding and abetting suit under § 10(b), the general antifraud provision of the Securities Exchange Act of 1934).

13. Pub. L. No. 104-67, 109 Stat. 737.

14. See *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) (holding that the Securities Exchange Act of 1934 authorizes a federal cause of action for rescission or damages to a corporation's shareholder in the context of a merger transaction completed pursuant to a false and misleading proxy statement).

15. The "loser pays" provision intended to make the losing side pay the attorneys' fees for the prevailing party.

16. In earlier versions of the bill, the plaintiff would have been required to plead the defendant's state of mind during each violation, without having had the benefit of discovery.

17. See generally *Securities Litigation Reform Proposals: Hearings on H.R. 1058 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 104th Cong. 131 (1995) (statement of Sheldon H. Elsen, Association of the Bar of the City of New York).

18. See Cox, *supra* note 2, at 11-20.

19. See Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994).

ally essential for protection. While law and economics may have applications in some areas of the law, applied here it seems out of touch with the realities of corporate decisionmaking.